

Part III - Administrative, Procedural, and Miscellaneous

Application of Employment Taxes to Statutory Stock Options

Notice 2002-47

I. Purpose and Overview

This notice provides that until Treasury and the Service issue further guidance, in the case of a statutory stock option, i.e., an incentive stock option (ISO) described in section 422(b) of the Internal Revenue Code (Code) or an option granted under an employee stock purchase plan (ESPP) described in section 423(b), the Service will not assess the Federal Insurance Contributions Act (FICA) tax or Federal Unemployment Tax Act (FUTA) tax, or apply federal income tax withholding obligations, upon either the exercise of the option or the disposition of the stock acquired by an employee pursuant to the exercise of the option. This notice further announces that Treasury and the Service anticipate that any final guidance that would apply employment taxes to statutory stock options will not apply to any exercise of a statutory stock option that occurs before the January 1 of the year that follows the second anniversary of the publication of the final guidance. This notice does not relieve individual taxpayers of the obligation to include compensation in income upon a disposition of stock acquired pursuant to the exercise of a statutory stock option and does not relieve employers of any of their reporting obligations.

II. Background

A. Notice 2001-14

On January 18, 2001, the Internal Revenue Service (Service) issued Notice 2001-14, 2001-6 I.R.B. 516, addressing the application of employment taxes to statutory stock options. Notice 2001-14 provides that, in the case of a statutory stock option exercised before January 1, 2003, the Service will not assess FICA or FUTA taxes upon the exercise of the option, and will not treat the disposition of stock acquired by an employee pursuant to the exercise of the option as subject to federal income tax withholding. The notice further provides that information reporting requirements continue to be applicable. The notice also announced the intention to issue administrative guidance clarifying the application of employment taxes to statutory stock options.

B. Proposed Regulations and Related Guidance

On November 13, 2001, the Service and the Treasury Department issued proposed regulations addressing the application of employment taxes to statutory stock options (66 Fed. Reg. 57023 (Nov. 14, 2001)). The proposed regulations provide that FICA and FUTA taxes apply when an individual exercises a statutory stock option and that federal income tax withholding does not apply when an individual exercises a statutory stock option. As proposed, the regulations would have been effective for exercises of statutory stock options occurring on or after January 1, 2003.

On November 13, 2001, the Service also issued two related notices containing proposed guidance: Notice 2001-72, 2001-49 I.R.B. 548, and Notice 2001-73, 2001-49 I.R.B. 549. In Notice 2001-72, the Service provides proposed rules regarding an

employer's federal income tax withholding and reporting obligations upon the disposition of stock acquired by an individual pursuant to the exercise of a statutory stock option. The rules would exempt the employer from any federal income tax withholding in such cases. However, under the proposed rules, an employer generally would still be required to make reasonable efforts to report any income on an employee's or former employee's Form W-2.

In Notice 2001-73, the Service provides proposed rules of administrative convenience intended to lessen the administrative burdens related to the application of FICA and FUTA taxes at the time of exercise of a statutory stock option. The rules would allow employers to deem the wages paid due to the exercise of a statutory stock option as being paid at any subsequent date or dates during the calendar year of the date of exercise. In addition, under the proposed rules, an employer would be allowed to spread the deemed wage payments over a period of dates. Notice 2001-73 also proposes other rules of administrative convenience that are intended to assist employers and employees in meeting their employment tax obligations.

III. Comments Received

The Service requested comments as to the proposed regulations and the proposed rules in the accompanying notices. Comments were submitted on a wide variety of issues raised by the application of employment taxes to statutory stock options, including whether imposition of the FICA and FUTA taxes upon an exercise of a statutory stock option was the correct interpretation of the law, and the extent of the administrative burdens upon employers and employees in administering the payments of the taxes. Recognizing the complexity of the issues raised by the proposed guidance

and comments, Treasury and the Service have determined that an extension of the moratorium is needed to provide adequate time to consider those issues.

IV. Interim Guidance

The Service and Treasury will continue to consider all of the comments received on the proposed regulations. However, until that review is completed and further guidance is issued, the Service (1) will not assess FICA or FUTA taxes upon the exercise of a statutory stock option or the disposition of stock acquired by an employee pursuant to the exercise of a statutory stock option, and (2) will not treat the exercise of a statutory stock option, or the disposition of stock acquired by an employee pursuant to the exercise of a statutory stock option, as subject to federal income tax withholding.

This Part IV does not relieve individual taxpayers of the obligation to include any compensation in income upon a disposition of stock acquired pursuant to the exercise of a statutory stock option and does not relieve employers of any of their reporting obligations. Regarding the reporting obligations, §1.6041-2(a)(1) of the Income Tax Regulations requires that, under certain circumstances, a payment made by an employer to an employee be reported on Form W-2 even if the payment is not subject to income tax withholding. Specifically, §1.6041-2(a)(1) generally requires reporting of a payment on the Form W-2 if the total amount of the payment, and any other payment of remuneration (including wages, if any) made to the employee (or former employee) that are required to be reported on Form W-2, aggregate at least \$600 in a calendar year. Therefore, a disqualifying disposition of stock acquired pursuant to the exercise of a statutory stock option which results in ordinary income generally will result in a reporting obligation on the Form W-2.

V. Effect on Other Documents

In recognition of the need of employers and statutory stock option plan administrators for adequate time to implement any guidance that may be forthcoming, the Service and Treasury anticipate that any final guidance that would apply employment taxes to statutory stock options will not apply to exercises of statutory stock options that occur before the January 1 of the year that follows the second anniversary of the publication of the final guidance.

VI. Drafting Information

The principal author of this notice is Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice contact Stephen Tackney at (202) 622-6040 (not a toll-free call).